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SUBJECT:UKRAINE: NEW GOU PROMISES SWIFT ACTION ON VAT, OPIC

Ref: A) Kyiv 156; B) 07 Kyiv 2985; C) 07 Kyiv 2531

KYIV 00000196 001.2 OF 005

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11. (SBU) Summary: In an exceptionally timely visit, Special Representative Frank Mermoud and Commerce DAS Paul Dyck received a well-coordinated and consistent message from the new GOU during their January 23-26 meetings in Kyiv. The GOU will improve transparency, attack corruption and address the USG's top economic and commercial concerns immediately, they heard repeatedly. The GOU promised to pay VAT arrears to U.S. companies within 30 days (and followed up on January 29 with initial payments of \$25 million), settle the OPIC claim, and strike a deal with Westinghouse for the delivery of nuclear fuel in time for a possible POTUS visit in April. Deputy Prime Minister Nemyrya announced the creation of a "Tymoshenko Transparency Initiative," and said he hopes to create a working group that would travel to Washington soon to solve outstanding issues with the USG. Nemyrya sought USG input for an investors' council that would advise PM Tymoshenko on how best to improve Ukraine's investment climate. Our visitors received a consistent message that GOU and Rada would act swiftly to complete WTO accession. The GOU confirmed that it will host the next Energy Security Summit of regional heads of state on May 22-23. Preparations for the 2012 European soccer championships are still advancing slowly, yet the new government clearly understands the challenges it faces in meeting the timeline for the mass spectacle.

12. (SBU) Comment: The new GOU has unleashed a broad agenda, made many promises and set tight timelines for itself. Without question, the program is overly ambitious, and we should expect that the government will not deliver on all that it has promised. At the same time, however, the meetings documented that the GOU is coordinating its message to us, and that it is listening to our concerns and taking them seriously. We should use the new government's energy and eagerness to advance agenda items where quick progress is possible, such as settling the OPIC claim, getting started on paying VAT arrears, and facilitating efforts to create an investors' council. We should also offer incentives to keep the new GOU focused when its elan invariably collides with the complexities of Ukrainian politics and reality. Well-timed high level visits

would help us keep the new government on track to improve the investment climate and address the outstanding problems in our bilateral commercial and economic relations. End summary and comment.

Value Added Tax (VAT)

13. (SBU) Serhiy Buryak, the new Chairman of the State Tax Administration (STA), told Mermoud, Dyck and the Ambassador on January 23 that VAT arrears due to U.S. grain exporters would be paid back within 30 days. Buryak said \$80 million in VAT refunds was overdue to U.S. companies. (Comment: On January 29 the STA paid back \$25 million to Cargill and Bunge. After these payments, VAT arrears owed to Cargill and Bunge are \$43 million and \$50 million respectively, according to the companies. This is still more than what the STA said was owed to the companies. The difference may partially be due to differing definitions of when VAT is overdue. End comment.) Amendments to the budget that the GOU plans to pass by March will address VAT arrears, Buryak said. Thereafter the GOU will work on a long-term solution to the many problems in Ukraine's VAT system. Buryak and other interlocutors told Mermoud and Dyck that VAT fraud linked to exports was widespread, forcing the GOU to examine exporters' VAT refund claims carefully. In any case the GOU planned to re-define its relationship with U.S. companies and base the interaction on partnership, Buryak said.

OPIC

14. (SBU) Deputy PM Nemyrya told Mermoud and the Ambassador that he hoped to lead a working group to Washington in the near future to discuss the OPIC claim and other outstanding bilateral economic and commercial problems. The USG side welcomed Nemyrya's initiative, but the Ambassador added that the GOU should go with a proposed OPIC solution in hand. The goal of the visit should be to reach

KYIV 00000196 002.2 OF 005

consensus with OPIC, he told Nemyrya. The two sides agreed that the visit could take place in late February or early March. Separately, Minister of Economy Danylyshyn indicated to the USG visitors that the new government was prepared to continue working on the proposed OPIC solution that the USG had discussed with the Yanukovych government. He said the issue would be under his personal control, and announced that Deputy Economy Minister Oksana Slyusarenko, who headed working level efforts on OPIC under the outgoing government, would remain in office and continue to lead the GOU efforts to find a solution.

Clear Sailing for WTO Accession

15. (SBU) Mermoud and Dyck congratulated their interlocutors on the January 25 approval of Ukraine's WTO Working Party Report. The WTO General Council is scheduled to vote on Ukraine's accession on February 5. Several interlocutors were optimistic that the Rada would ratify WTO accession long before the July 4 deadline requested by Ukraine. Both Nemyrya and Danylyshyn said the Cabinet would send drafts of the final legislation for accession to the Rada by the end of January, and reiterated that Ukraine would implement all its WTO obligations. Valentina Zavalevska, Deputy Minister of Agriculture, said the GOU recognized that the continued zero VAT on agriculture in the new budget violated the commitments the GOU made in its accession negotiations. She confirmed that the draft legislation would reintroduce VAT for farmers. The issue was a difficult one for Ukraine, she claimed, because producers would lose UAH 7 billion (about \$1.38 billion). She said the GOU would introduce a WTO-compliant scheme for compensating the farmers' losses, but did not elaborate. Party of Regions Rada deputy Iryna Akimova, who is also the opposition's Shadow Minister of Economy, told Mermoud and Dyck that broad partisan support for WTO membership existed in the Rada, even among many Communists. She was confident that the Rada would pass the necessary legislation in a timely matter. The only risk, she said, could arise if Tymoshenko tried to insert other agenda items into the draft legislation. Akimova would not speculate whether the Party of Regions would vote with the governing

coalition when the ratification comes up in the Rada.

¶16. (SBU) The new government appears to have no consensus on how to implement its obligation, codified in Ukraine's bilateral WTO agreement with the U.S., to remove grain export quotas upon accession. Zavalevska said the government could increase the quotas to 3.5 million tons through the end of the marketing year (June 30); currently, however, the quota remains at the 1.2 million ton level established on January 1. She did not indicate when, or if, the GOU would fully abolish quotas, and repeated during the course of her meeting with Mermoud and Dyck that Ukraine needed to regulate the grain market to guarantee adequate supplies for the domestic market, and to ensure that food price inflation does not spiral out of control. Separately, Deputy Minister of Economy Natalia Boytsun told EconOff that her ministry had pressed hard to accelerate the liberalization of grain export quotas, yet the Ag Ministry remained stubbornly opposed and only conceded the figures that Zavalevska had announced. Boytsun said that market circumstances should allow the GOU to abolish quotas for some grain exports, such as corn.

FTA Negotiations with EU to Begin Soon

¶17. (SBU) Sergiy Korsunsky, Director General for International Economic Cooperation at the MFA, told Mermoud the EU has already offered to launch formal negotiations on a free trade agreement on February 7, two days after the WTO General Council approves Ukraine's membership. Nemyrya told Mermoud and the Ambassador that the FTA negotiations with the EU will be challenging. The GOU hoped to reach an agreement in two years. Such a time frame was chosen deliberately to ensure that Ukraine did not create any unrealistic expectations that it could not fulfill.

Investors' Council

¶18. (SBU) Nemyrya said the new GOU planned to create an investors' council to advise it on how best to improve the investment climate. Nemyrya said he envisaged two levels for the council. The first

KYIV 00000196 003.2 OF 005

level would consist of CEOs from companies already present in the Ukrainian market and from firms not yet in Ukraine but contemplating an entry. This group would advise the Prime Minister directly. A second level would consist of several working groups focusing on particular sectors. The working groups would develop policy suggestions for the top level. Nemyrya said the GOU would work with the AmCham and the European Business Association to identify possible members, and asked for Embassy's support and recommendation. The Ambassador applauded the initiative and said it would ask both the AmCham and the U.S. Ukraine Business Council to submit recommendations directly to Nemyrya.

Corruption and the "Tymoshenko Transparency Initiative"

¶19. (SBU) Transparency was a mantra that Mermoud and Dyck heard repeatedly. They attended a hastily-called gathering with the international and Ukrainian business community on January 24 in which Prime Minister Tymoshenko and Nemyrya discussed the new government's plan of action to reform the economy, attack corruption and boost transparency in public life. The GOU published the plan on the CabMin website and plans to submit it to the Rada in early February. At the event, Nemyrya announced what he called the "Tymoshenko Transparency Initiative" or TTI. In a US-friendly gesture, he specifically recognized Special Representative Mermoud "and his delegation" who were in Kyiv for meetings with the new government. In his bilateral meeting with Mermoud and the Ambassador, Nemyrya said TTI would be an across-the-board program involving all ministries, and aimed at changing the way the government worked.

¶10. (SBU) Both Deputy PM Nemyrya and Economy Minister Danylyshyn asked the USG side for increased engagement by the Millennium Challenge Corporation (MCC). Danylyshyn asked whether the MCC could also support economic reform in Ukraine. The Ambassador reminded

him that the MCC Threshold program was focused on combating corruption. Nemyrya promised that the new GOU would reconstitute the MCC Threshold board in a timely manner.

¶11. (SBU) Valeriy Khoroshkovskiy, Chairman of the State Customs Service, elaborated plans to improve the efficiency of the agency notorious for corruption. He said Customs planned to automate customs procedures and bring them in line with EU standards. In March, Customs would roll out an electronic customs declaration system meant to ease the burden on businesses. The system would not be fully operational, however, until the multitude of other agencies involved in the customs clearance process got on board. Khoroshkovskiy said he understood that bureaucratic obstacles were linked to corruption and added that "reeducation" of Customs' 18,000 employees would be a long-term struggle.

¶12. (SBU) Khoroshkovskiy confirmed that Tymoshenko would resurrect the anti-smuggling campaign of her previous premiership that reduced smuggling and led to a growth of customs revenue. The new campaign would target both "black goods" -- those smuggled across the border without being stopped -- and "grey goods" -- those whose declared customs value is intentionally lowered to avoid customs fees. On combating the latter, Khoroshkovskiy asked for U.S. assistance in better sharing customs valuation information so that Ukrainian Customs could check invoices for imported products against invoices for the same products when they left their country of origin. Khoroshkovskiy agreed to Mermoud and Dyck's suggestion to reconstitute a customs working group with the AmCham.

¶13. (SBU) Minister of Transport and Communications Yosyp Vinsky reiterated Tymoshenko's call for transparency in all ministry dealings and stamping out all forms of corruption. Vinsky stressed that the ministry was not afraid to take radical steps at reform to improve its reputation. Dyck addressed a project to build a new terminal at Kyiv's Boryspil airport, saying that the USG urged the GOU to ensure a transparent tender, and added that Bechtel had expressed interest in the project. Vinsky promised complete and clear transparency and said new rules would encourage participation from a wide range of bidders. He also promised a fair process for the privatization of Ukrtelecom, which the new GOU hopes to carry out this year. If Ukraine were serious about integration with Europe, he said, it must make its business dealings transparent and

KYIV 00000196 004.2 OF 005

fair.

Energy Issues

¶14. (SBU) Minister of Energy Yuriy Prodan reiterated the GOU desire, made during an earlier meeting with the Ambassador (reftel) to strike a deal with Westinghouse over the delivery of nuclear fuel in time for a possible POTUS visit in April. He also confirmed that Ukraine would host the Energy Security Summit on May 22-23 and said his ministry was planning a "donor conference" for Ukraine's gas transit system in September. Prodan promised to share a background paper on the donor conference with Embassy. (Comment: the title may be a misnomer. Press reporting indicates that the conference will not focus on gathering donations, but rather target attracting foreign investment for the modernization of Ukraine's gas transit system. End comment).

¶15. (SBU) The MFA's Korsunsky elaborated on the May 22-23 energy summit in a separate discussion with Mermoud. Like its predecessor in Vilnius, the summit would focus on the "Baltic-Black Sea-Caspian Transit Corridor," he said. Planning was in an absolute nascent stage. Many foreign missions had been informed of the date, but the GOU still did not have a clear concept, nor had it decided whether to hold the event in Kyiv or elsewhere. The MFA was tasked with the planning, but Korsunsky said the Ministry of Energy would need to do the heavy lifting. Korsunsky said he envisaged one day of high level meetings attended by heads of state, followed by a day focused on commercial energy issues and attended by high level private sector representatives. The commercial component should allow discussion of a broad range of energy-related issues which have relevance for energy security in the region, he said. He acknowledged that,

ideally, the summit should not focus on promoting the Odesa-Brody pipeline, but he added, "unfortunately, that will happen, and it's something we can't avoid." Korsunsky urged the USG to send a representative with sufficient seniority to meet with President Yushchenko. He shared with Mermoud a draft declaration on energy security which he hoped the visiting heads of state might sign off on as a "Kyiv Declaration." Mermoud said he would probe USG interest in supporting such a declaration. (Note: We believe Korsunsky's declaration is similar to a proposal he floated last fall (ref C) for possible UNGA action.)

¶16. (SBU) Energy Minister Prodan reported that the production sharing agreement (PSA) with U.S.-based Vanco was moving forward and that he would meet with Vanco representatives that same day to clarify any outstanding issues. He added that the Spent Nuclear Fuel Storage facility project to be constructed in the Chernobyl exclusion zone by U.S.-based Holtec was also progressing, and that public hearings (for the population living near the exclusion zone), governmental approval of the feasibility study, and ultimate parliamentary approval for the project would be necessary before construction could begin. Prodan was confident all necessary approvals would be granted before 2009. Dyck mentioned that Houston-based Marathon Oil had some concerns about licensing for oil and gas exploration, joint ventures, and PSAs for both shallow and deep water exploration. Deputy Minister Volodymyr Makukha said he would continue to meet with Marathon representatives to resolve any concerns. Prodan invited Marathon to present any relevant proposals to the Ministry for amending current laws on licensing, joint ventures, and production sharing agreements.

Euro 2012

¶17. (SBU) Yevhen Chervonenko, Chairman of the newly created State Agency responsible for the 2012 European soccer championships, which Ukraine will co-host with Poland (ref B), explained at length the challenges that Ukraine faces in preparing for the month-long spectacle that is expected to attract about 1 million visitors to the four cities where games will be held. He confirmed reports of infighting within the government, and between the government and the Ukrainian soccer federation led by oligarch Hryhoriy Surkis. Three billion U.S. dollars will be allocated from the national budget for Euro 2012 projects, \$1 billion from local budgets, and \$21 billion, Ukraine hopes, will come from foreign investors. He and others said that the GOU hopes to pass a law on public-private partnerships

KYIV 00000196 005.2 OF 005

(PPPs) to allow PPPs to be used for investment projects. Chervonenko said oligarchs who are soccer enthusiasts will ensure that the cities that serve as their power base will be ready in time -- Rinat Akhmetov in Donetsk, Ihor Kolomoyskyy in Dnipropetrovsk and Oleksandr Yaroslavsky in Kharkiv. Preparations for Kyiv remain a challenge, where a dispute among oligarchs over construction of a shopping center may derail plans to host the championship game in the city's Olympic Stadium. The GOU will also have to move forward quickly to modernize the country's airports and transportation infrastructure, he said.

¶18. (U) Special Representative Mermoud and Commerce DAS Dyck cleared this cable.

Taylor